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## Chiarella v. United States

Kerry Cunningham Feffer

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# CHIARELLA v. UNITED STATES

## I. INTRODUCTION

The Securities Exchange Act of 1934<sup>1</sup> (the Act) is part of a comprehensive statutory scheme that was enacted to restore and promote confidence in the financial markets of the United States after the stock market crash of 1929.<sup>2</sup> Section 10(b)<sup>3</sup> of the Act and rule 10b-5<sup>4</sup> promulgated thereunder expressly prohibit the use of manipulative and deceptive devices in connection with the purchase or sale of any security. Courts have been consistent in finding violations of these antifraud provisions where defendants have made material misrepresentations. Moreover, in misrepresentation cases, the status of the person making the disclosure is irrelevant.<sup>5</sup> Courts have not been consistent, however, in finding violations of the antifraud provisions in cases where the defendant failed to disclose material nonpublic information. Liability for nondisclosure has turned on whether the nondisclosing party had a duty to disclose. Determining whether there is a duty to disclose has been a difficult and much litigated issue.<sup>6</sup>

The United States Supreme Court recently had occasion to decide under what circumstances a duty to disclose would arise. In *Chiarella v.*

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1. 15 U.S.C. §§ 78a-78kk (1976).

2. Barnet, *Neither a Tipper nor a Tippee Be*, 8 Hous. L. Rev. 278, 279 (1970).

3. Section 10(b) of the Act, 15 U.S.C. § 78j(b), prohibits the use "in connection with the purchase or sale of any security . . . [of] any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

4. The SEC promulgated rule 10b-5 pursuant to its rulemaking authority in § 10(b). Rule 10b-5 provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1980).

5. W. PAINTER, *FEDERAL REGULATION OF INSIDER TRADING* 137 (1968). Clause (b) of rule 10b-5 expressly prohibits material misstatements. See *supra* note 4; Kardon v. National Gypsum Co., 73 F. Supp. 798 (E.D. Pa. 1947).

6. E.g., Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787 (2d Cir. 1969), cert. denied, 400 U.S. 822 (1970); Kardon v. National Gypsum Co., 73 F. Supp. 798 (E.D. Pa. 1947).

*United States*,<sup>7</sup> the Court reviewed the criminal conviction<sup>8</sup> of a purchaser of stock<sup>9</sup> under the antifraud provisions. Because the purchaser was neither an insider nor a tippee, the conviction could not be affirmed based on settled legal principles. The Court reversed the conviction and rejected the parity of access to information theory<sup>10</sup> that had been adopted by the Second Circuit.

The *Chiarella* Court also considered two other theories. The Court concluded that a duty to disclose would arise from a relationship akin to a fiduciary relationship. This theory evolved from common law concepts of fraud. If that theory were to become the sole basis for rule 10b-5 liability, however, it would represent an unwarranted substantive

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7. 445 U.S. 222 (1980), *rev'g* 588 F.2d 1358 (2d Cir. 1978).

8. *Chiarella* arose in the context of a criminal action under the antifraud provisions of the Act. Because the provisions have both criminal and civil implications, certain problems of statutory construction are presented. It has been established that except for issues of intent and burden of proof, criminal and civil liability under the Act are coextensive. *United States v. Charnay*, 537 F.2d 341, 348 (9th Cir.), *cert. denied*, 429 U.S. 1000 (1976); *United States v. Peltz*, 433 F.2d 48, 53 (2d Cir. 1970). Also, it has been held that the statute in civil cases should be flexibly construed to achieve the most protection for securities investors. *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972); *A.T. Brod & Co. v. Perlow*, 375 F.2d 393 (2d Cir. 1967); *SEC v. Capital Gains Research Bureau*, 375 U.S. 180 (1963). In *United States v. Persky*, 520 F.2d 283 (2d Cir. 1975), Judge Kaufman noted the inherent conflict that arises in interpretation of civil and criminal statutes. "Perhaps the most interesting [issue] is the apparent dissonance between the general rule that criminal statutes are to be strictly construed in favor of the accused . . . and the realization that the civil incarnations of the anti-fraud provisions have, as remedial legislation, been openly and avowedly construed broadly." *Id.* at 287.

While it is uncertain from the *Chiarella* opinion how much of an effect the fact that this was a criminal action had on the Court's decision, the Court did note a concern about liberal interpretations of the statute. The Court pointed out that "a judicial holding that certain undefined activities 'generally are prohibited' by § 10(b) would raise questions whether either criminal or civil defendants would be given fair notice that they have engaged in illegal activity." 445 U.S. at 235 n.20. The Court, however, took no further notice that this was a criminal action, and it is likely that the opinion will have an equal impact on civil cases.

9. The Court found it worth noting that *Chiarella* was the first case in which criminal liability had been imposed upon a purchaser for § 10(b) nondisclosure. 445 U.S. at 235 n.20. Although *Chiarella* was a purchaser of stock, it is apparent that the Court's opinion would be the same were he a seller. The Court referred, without comment, to the reasoning employed in *Cady, Roberts & Co.*, 40 S.E.C. 907 (1961), that the insider assumes a fiduciary relation to the buyer by the very sale. *Id.* at 914 n.23 (citing *Gratz v. Claughton*, 187 F.2d 46, 49 (2d Cir.), *cert. denied*, 341 U.S. 920 (1951)).

10. The parity of access theory is discussed *infra* notes 54-68 and accompanying text. The Supreme Court's decision dealt only with nondisclosure cases. It did not deal with cases in which representations are made. The part of the indictment based on clause (b) of rule 10b-5, see *supra* note 4, was dismissed at trial since "the petitioner made no statements at all in connection with the purchase of stock." 445 U.S. at 225 n.5.

restriction of the antifraud provisions which were intended to be broad and remedial.

The Court also considered a misappropriation theory<sup>11</sup> under which a duty to disclose would arise if a party to a securities transaction wrongfully obtained material nonpublic information. This theory, expressly endorsed by four Justices,<sup>12</sup> is consistent with the policies and purposes underlying the Act and should be adopted as an additional test for nondisclosure liability.

## II. FACTS OF THE CASE

Vincent Chiarella was employed by Pandick Press, a financial printer, from 1975 to 1976. In his capacity as a "markup man," Chiarella had access to many confidential documents, including documents pertaining to prospective tender offers. When such documents were submitted to Chiarella, the vital information concerning the identities of the bidding and target corporations was either omitted or encoded<sup>13</sup> to insure confidentiality until the information was publicly disclosed.

Chiarella was a knowledgeable stock trader.<sup>14</sup> Based upon his own knowledge of the stock market and the information contained in the documents he set for printing, Chiarella was able to deduce the names of the corporations involved in five impending takeover bids.<sup>15</sup> Disregarding notices posted throughout the print shop that use of customer information for personal gain was illegal and against company rules, Chiarella purchased stock in each of the target companies. As each takeover bid was made public, Chiarella sold his shares, eventu-

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11. See *infra* notes 81-88 and accompanying text.

12. The theory of misappropriation was advocated by the Chief Justice in his dissent, 445 U.S. at 239 (Burger, C.J., dissenting); see *infra* notes 81-88 and accompanying text. Justice Blackmun, joined by Justice Marshall in dissent, agreed with the theory but would have also endorsed an even more liberal construction of the antifraud provisions. 445 U.S. at 246 (Blackmun, J., dissenting). Justice Brennan, in his concurrence, would have held misappropriation as the proper theory, but concurred in the judgment on the basis that the theory was not properly presented to the jury. *Id.* at 239 (Brennan, J., concurring).

13. *United States v. Chiarella*, 588 F.2d 1358, 1363 (2d Cir. 1978), *rev'd*, 445 U.S. 222 (1980). For example, one of the transactions involved a tender offer of USM Corporation stock by Emhart Corporation. The documents submitted to the printer identified "U.S.C. Corp." and "Arabia Corp." as the principals.

14. Chiarella had more than a passing interest in securities markets, as evidenced by his conversations with his broker as many as ten to fifteen times a day. 588 F.2d at 1363.

15. Four of the transactions involved tender offers and the other involved a merger. The parties stipulated that the form of the takeover was not significant. *Id.* at 1363 n.2. Additionally, the parties stipulated that the information regarding the takeovers was material. *Id.* at 1364 n.5.

ally netting over \$30,000 in profits in fifteen months.<sup>16</sup>

In 1977, the Securities and Exchange Commission (SEC) began an investigation into Chiarella's activities. On May 24, 1977, Chiarella entered into a consent decree with the SEC in which he agreed to disgorge his profits for eventual distribution to the sellers of the target stock.<sup>17</sup> On the same day, he was discharged from Pandick Press.

In January 1978, Chiarella was indicted<sup>18</sup> on seventeen counts of criminal violations of section 10(b) and SEC rule 10b-5<sup>19</sup> and was later convicted by a jury on each count.<sup>20</sup> Chiarella appealed<sup>21</sup> his conviction and contended that because he was neither an insider, nor owed any fiduciary duty to selling shareholders of the target companies, he was not subject to a duty to disclose.

A divided Second Circuit affirmed the conviction, holding that a duty to disclose arises from regular access to market information.<sup>22</sup> The court concluded that it was irrelevant that Chiarella was not an insider of the target companies because "[a] financial printer such as Chiarella is as inside the market itself as one could be."<sup>23</sup> Noting that a major purpose of the antifraud provisions is to protect the integrity of the marketplace, the Second Circuit imposed an affirmative duty of disclosure on the market insider<sup>24</sup> and held Chiarella's silence to be a violation of rule 10b-5.<sup>25</sup> The Supreme Court granted certiorari<sup>26</sup> and reversed Chiarella's conviction.

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16. *Id.* at 1363.

17. *Id.* at 1364.

18. The action was brought under § 32(a) of the Act, 15 U.S.C. § 78ff(a), which provides for criminal sanctions against a person who wilfully violates any provision of the Act or of any rule thereunder, the violation of which is made unlawful. While the Supreme Court did not address the issue, the appellate court found that Chiarella had the requisite scienter. *United States v. Chiarella*, 588 F.2d at 1369-73.

19. *Chiarella v. United States*, 445 U.S. at 225 n.3. Chiarella was indicted one count for each letter he received confirming purchase of the shares.

20. Chiarella was sentenced to one year imprisonment. After one month, his sentence was suspended and he was placed on probation for five years. 588 F.2d at 1364 n.7.

21. The district court, in *United States v. Chiarella*, 450 F. Supp. 95 (S.D.N.Y. 1978), denied a motion to dismiss on the grounds that Chiarella was guilty of fraud as to the sellers of the target stock and as to the offering companies.

22. 588 F.2d at 1368. The court derived its test from the concept of "quasi-insiders" discussed in ALI FED. SEC. CODE § 1602. The quasi-insider is one who has regular access to market information and would be liable under § 10(b) only in egregious cases. 588 F.2d at 1365.

23. *Id.* at 1364.

24. *Id.* at 1365.

25. *Id.* at 1367-69.

26. 441 U.S. 942 (1979).

### III. THE SUPREME COURT'S DECISION

#### A. Development of Nondisclosure Liability

In reaching its decision, the *Chiarella* Court briefly discussed the development of the duty to disclose. Early common law actions for fraud and deceit could only be based on outright misrepresentations.<sup>27</sup> Later, fraud actions were allowed in cases of nondisclosure provided a duty to disclose existed. That duty, however, was only imposed where there existed a fiduciary relationship or some other relationship of trust and confidence between the parties to the transaction.<sup>28</sup> Under the majority rule that developed at common law, a corporate insider only owed a duty of disclosure to his corporation. Therefore, in stock transactions with shareholders, the insider could deal at arm's length with no disclosure obligation.<sup>29</sup> Moreover, there was no requirement that insiders disclose information when trading occurred on a stock exchange.<sup>30</sup>

The Securities Exchange Act of 1934 was designed to insure full disclosure of information to the investing public.<sup>31</sup> One of the primary

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27. 3 L. LOSS, *SECURITIES REGULATION* 1433-34 (2d ed. 1961) [hereinafter L. Loss]. The common law elements of deceit are:

1. A false representation of a material fact made by the defendant.
2. Knowledge on the part of the defendant that the statement is false.
3. Reliance on the part of the plaintiff.
4. Damage to the plaintiff resulting from his reliance.

W. PROSSER, *HANDBOOK OF THE LAW OF TORTS* 685-86 (4th ed. 1971).

28. Jennings, *Insider Trading in Corporate Securities: A Survey of Hazards and Disclosure Obligations under Rule 10b-5*, 62 NW. U. L. REV. 809, 810 (1968) [hereinafter cited as Jennings].

29. *Goodwin v. Agassiz*, 283 Mass. 358, 186 N.E. 659 (1933); FLETCHER, *CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* § 1168.1, at 283 (perm. ed. rev. 1975) [hereinafter cited as FLETCHER].

The "Kansas Rule," adopted by a minority of the states, considered insiders as trustees for individual shareholders and included nondisclosure as grounds for an action in deceit. *Stewart v. Harris*, 69 Kan. 498, 77 P. 277 (1904); *Oliver v. Oliver*, 118 Ga. 362, 45 S.E. 232 (1903). This rule went to the extreme of holding that an insider could not purchase stock from a stockholder without giving him the benefit of *any* official knowledge he possessed regarding the value of the stock. FLETCHER, *supra* § 1168.2, at 288. The special facts doctrine, first enunciated in *Strong v. Repide*, 213 U.S. 419 (1909), imposed a limited duty on insiders to disclose the value of shares when dealing with a shareholder, even without a fiduciary relationship, if "special facts" existed. *Id.* at 431. See also *Janigan v. Taylor*, 344 F.2d 781 (1st Cir. 1965). Special knowledge was information which a shareholder could not find in the company books or financial reports. Conant, *Duties of Disclosure of Corporate Insiders Who Purchase Shares*, 46 CORNELL L.Q. 53, 59 (1960). However, both the minority rule and the special facts doctrine dealt only with face-to-face transactions. Jennings, *supra* note 28, at 811-12.

30. A. JACOBS, *THE IMPACT OF 10b-5* § 66.02(a) (rev. ed. 1980).

31. See *SEC v. National Sec., Inc.*, 393 U.S. 453, 466 (1968); *Shapiro v. Merrill Lynch*,

purposes of the broad antifraud provisions of the Act was to outlaw the use of inside information by corporate insiders to the detriment of the uninformed public securities holders.<sup>32</sup> Section 10(b) was designed as a catchall provision to prevent fraudulent practices in the purchase and sale of securities. That section and rule 10b-5 are broader in scope than traditional common law fraud actions and were designed to reach misleading or deceptive activities whether or not they are technically sufficient to sustain a common law action.<sup>33</sup>

Rule 10b-5 expressly prohibits *any* person, insider or not, from telling a material lie or half-truth in connection with the purchase or sale of any security.<sup>34</sup> The rule does not expressly state, however, whether nondisclosure is actionable.

The SEC took an important step in nondisclosure liability in *Cady, Roberts & Co.*<sup>35</sup> In that case, the SEC determined that a broker who received nonpublic information from a director of a corporation was under an affirmative obligation to disclose material information. *Cady, Roberts* involved a partner in a brokerage firm who, immediately after the corporation had decided to cut its dividend rate and before the information was publicly disclosed, sold Curtiss-Wright stock.<sup>36</sup> The

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Pierce, Fenner & Smith, Inc., 495 F.2d 228, 235 (2d Cir. 1974); *Crane Co. v. Westinghouse Air Brake Co.*, 419 F.2d 787, 793 (2d Cir. 1969), *cert. denied*, 400 U.S. 822 (1970).

32. In an early rule 10b-5 case, Judge Leahy explained the scope and purpose of the rule:

The duty of disclosure stems from the necessity of preventing a corporate insider from utilizing his position to take unfair advantage of the uninformed minority stockholders. It is an attempt to provide some degree of equalization of bargaining position in order that the minority may exercise an informed judgment in any such transaction. . . . One of the primary purposes of the Securities Exchange Act of 1934 . . . was to outlaw the use of inside information by corporate officers and principal stockholders for their own financial advantage to the detriment of uninformed public security holders.

*Speed v. Transamerica Corp.*, 99 F. Supp. 808, 829 (D. Del. 1951), *aff'd*, 235 F.2d 369 (3d Cir. 1956).

33. *Herpich v. Wallace*, 430 F.2d 792, 802 (5th Cir. 1970); *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir. 1965).

34. See *Kardon v. National Gypsum Co.*, 73 F. Supp. 798, 801 n.1 (E.D. Pa. 1947); *supra* note 4. Thus, a person with no fiduciary duty or relationship to the company is in violation of rule 10b-5 if he makes a material misrepresentation in connection with the purchase or sale of securities. Fleischer, *Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceeding*, 51 VA. L. REV. 1271, 1277 (1965). A more difficult issue is presented, however, when nondisclosure constitutes the fraud. Fleischer, *An Initial Inquiry Into the Responsibility to Disclose Market Information*, 121 U. PA. L. REV. 798, 803 (1973) [hereinafter cited as Fleischer].

35. 40 S.E.C. 907 (1961).

36. *Id.* at 908-09. In early November, 1959, Gintel, the partner, purchased almost 11,000 shares of Curtiss-Wright stock for customers' discretionary accounts. *Id.* at 908. Following the public disclosure of a new type of engine, the stock increased in price. *Id.* Gintel

partner had received this information from an associate who was also a director of Curtiss-Wright. The Commissioner held that the partner owed a duty to disclose this information and recognized two policies underlying the imposition of the duty:

[F]irst, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing. . . . Thus our task here is to identify those persons who are in a special relationship with a company and privy to its internal affairs, and thereby suffer correlative duties in trading in its securities.<sup>37</sup>

Thus, *Cady, Roberts* was important to the development of nondisclosure liability in two respects. First, nondisclosure became actionable without requiring the plaintiff to prove the common law elements of fraud.<sup>38</sup> Second, and more importantly, the decision expanded the group which owed a duty to disclose beyond corporate officers, directors, and controlling shareholders. The obligations of an insider were imposed on the broker because of a special relationship giving him access to inside information.<sup>39</sup>

Based in part on the reasoning and test developed in *Cady, Roberts*, the Second Circuit, in *SEC v. Texas Gulf Sulphur*,<sup>40</sup> suggested that

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immediately began selling Curtiss-Wright stock. These sales were prior to the company's decisions to lower its dividend. *Id.* Upon hearing of the intended cut in the dividend, Gintel executed more sell orders. *Id.* at 909. Gintel's contention that these latter sales were part of his prior plan to liquidate was rejected by the SEC because they occurred far more quickly than the earlier sales, which occurred before he learned the information. *Id.* at 916.

37. *Id.* at 912 (footnote omitted).

38. *Cady, Roberts* was important in that it construed actions under the rule to be broader than at common law. At common law, actions for fraud or deceit were based on express misrepresentations of a material fact. L. Loss, *supra* note 27, at 1432. At common law, no action would lie for a seller of securities because there would have been no fiduciary duty existing between the seller and the buyer. *Id.* at 1434-35. *Cady, Roberts*, however, interpreted rule 10b-5 to include situations broader than the common law and imposed the same duty of disclosure on a corporate insider when selling stock as when purchasing securities. The Commissioner noted that "[t]here is no valid reason why persons who purchase stock from an officer, director or other person having the responsibilities of an 'insider' should not have the same protection afforded by disclosure of special information as persons who sell stock to them." 40 S.E.C. at 913 (emphasis in original).

39. 40 S.E.C. at 912. The Commissioner did not explain the nature of the special relationship. However, the test has been used to impose liability on persons who are not corporate officers, directors, or majority shareholders. *SEC v. Texas Gulf Sulphur*, 401 F.2d 833, 848-55 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

40. 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).



the reach of the statute in nondisclosure cases might be expanded even further. In *Texas Gulf Sulphur*, certain directors and corporate employees purchased stock in their corporation without disclosing nonpublic information regarding important mineral discoveries, which, if known, would have had an impact on the price of the shares.<sup>41</sup> In holding the directors and employees liable under section 10(b), the court did not base liability on any special insider relationship.<sup>42</sup> It noted that the relationship discussed in *Cady, Roberts* was not a stringent test, but that the statute was intended to preclude *anyone* who had inside information from trading, unless he first disclosed that information. The court stated that:

Insiders, as directors or management officers are, of course, by this Rule precluded from so unfairly dealing, but the Rule is also applicable to one possessing the information who may not be strictly termed an "insider" within the meaning of section 16(b) of the [Exchange] Act. . . . Thus, anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.<sup>43</sup>

While the *Texas Gulf Sulphur* decision suggested that all trading on inside information was prohibited, the Second Circuit in *General Time Corp. v. Talley Industries*,<sup>44</sup> held that rule 10b-5 does not place an affirmative duty on a corporation making stock purchases to disclose its intention to make a tender offer at a higher price.<sup>45</sup>

The Second Circuit, in *Texas Gulf Sulphur*, reserved opinion as to

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41. *Id.* at 843-48. *Texas Gulf Sulphur* was a corporation engaged in the mining of certain minerals. The company discovered what appeared to be a very promising source of zinc, copper and silver. *Id.* Before the importance of the find was disclosed, certain corporate employees purchased stock in the corporation. *Id.* at 843-44.

42. *See id.* at 848.

43. *Id.* (dictum). Although *Texas Gulf Sulphur* went beyond *Cady, Roberts*, all of the defendants were, in fact, corporate insiders or employees. *Id.* at 845.

44. 403 F.2d 159 (2d Cir. 1968), *cert. denied*, 393 U.S. 1026 (1969).

45. Although plans for the merger would increase the value of stock, the court stated: "We know of no rule of law, applicable at the time, that a purchaser of stock, who was not an 'insider' and had no fiduciary relation to a prospective seller, had any obligation to reveal circumstances that might raise a seller's demands and thus abort the sale." *Id.* at 164.

*General Time* was decided before the enactment of the Williams Act. Section 13(d)(1) of the 1934 Act, 15 U.S.C. § 78m(d)(1) (1976), permits persons making tender offers to purchase up to five percent of the target company securities without disclosing their intentions.

liability of tippees in nondisclosure cases.<sup>46</sup> The issue finally was decided by the Second Circuit in *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*<sup>47</sup> The *Shapiro* court extended the abstain or disclose rule to tippees of corporate insiders because they have the duty not to profit from the use of inside information which they know is confidential and know or should know came from a corporate insider.<sup>48</sup>

The United States Supreme Court added a new dimension to the duty to disclose in *Affiliated Ute Citizens v. United States*,<sup>49</sup> where 10b-5 liability was imposed on a bank and its agents who were neither corporate insiders nor tippees. The bank agreed to act as a transfer agent for a group of Indian shareholders in the Ute Distribution Corporation. There were two markets for the stock: one involving sales of stock from Indians to non-Indians through the bank, and another involving a resale market consisting of non-Indians only. The Indians were unaware of the existence of the second market where stock prices were significantly higher than in the primary market. The *Affiliated Ute* Court found that the bank and its agents were liable and observed that the agents had been active in encouraging a market for the shares and that the Indians had a right to know about the existence of the second market.<sup>50</sup>

Noting the development of nondisclosure liability and using *Affiliated Ute* as precedent, the Second Circuit, in *United States v. Chiarella*,<sup>51</sup> formulated a new test for 10b-5 liability. The court stated that "[a]nyone—corporate insider or not—who regularly receives material nonpublic information may not use that information to trade in securities without incurring an affirmative duty to disclose."<sup>52</sup> Essentially,

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46. 401 F.2d at 852-53. There was evidence that one of the insiders had tipped the information regarding mineral discoveries to outsiders, but the court withheld judgment as to the liability of these tippees because they were not defendants in the subject proceeding. *Id.*

47. 495 F.2d 228 (2d Cir. 1974).

48. The tippee was held to be liable under rule 10b-5 if he knew or should have known that the information came from a corporate insider and that the information was nonpublic. *Id.* at 238. Thus, the relationship aspect is found in the tipper's position, and the tippee need only know the information came from an inside source. See *In re Investors Management Co.*, [1970-1971 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78,163 (July 29, 1971).

49. 406 U.S. 128 (1972).

50. *Id.* at 151-53. While it appears that the case held that use of market information may be a violation of the rule, there was, in fact, a relationship element in that the bank was active in encouraging the Indians to sell, and had undertaken to act on behalf of the Indian shareholders. *Id.* at 152. See Fleischer, *supra* note 34, at 819-20.

51. 588 F.2d 1358 (2d Cir. 1978), *rev'd*, 445 U.S. 222 (1980).

52. *Id.* at 1365 (emphasis in original).

the Second Circuit adopted a parity of access to information theory.<sup>53</sup>

### B. Parity of Access to Information

The Supreme Court reversed Chiarella's conviction<sup>54</sup> because it concluded that neither section 10(b) itself, nor its legislative history, lent support to the theory that all traders have equal access to information before trading in securities.<sup>55</sup> It expressly rejected parity of access to information as a theory for liability under section 10(b) or rule 10b-5.<sup>56</sup> This theory is based on a policy of protection of the integrity of the marketplace by insuring that all investors in securities are dealing with the same set of facts.<sup>57</sup> Prior to the Second Circuit's opinion in *Chiarella*, no case had held parity to be the rule, but the theory had received support in other opinions.<sup>58</sup> Indeed, the duty of disclosure imposed on corporate insiders had as its foundation the unfairness of allowing a corporate insider to take advantage of an uninformed minority shareholder.<sup>59</sup> Additionally, the concept of fairness was recognized by the Commissioner in *Cady, Roberts*, a case on which the Court relied in establishing the relationship prerequisite.<sup>60</sup>

Parity of access to information did receive support from two dissenting justices. In dissent, Justice Blackmun, joined by Justice Marshall, supported the parity of access to information rule. Justice Blackmun would have held that "persons having access to confidential material information that is not legally available to others generally are prohibited by Rule 10b-5 from engaging in schemes to exploit their structural informational advantage through trading in affected securities."<sup>61</sup> He noted that "Congress itself has recognized [that] it is integral to this purpose 'to assure that dealing in securities is fair and without undue preferences or advantages among investors.'"<sup>62</sup> Both

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53. See *infra* notes 54-68 and accompanying text.

54. 445 U.S. 222 (1980).

55. *Id.* at 233-34.

56. *Id.* at 232. The Court found two defects in this approach: (1) not every instance of financial unfairness constitutes fraudulent activity under section 10(b) (citing *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 474-75 (1977)) and (2) the element required to make silence fraudulent—a duty to disclose—is absent. 445 U.S. at 232.

57. Fleischer, *supra* note 34, at 816.

58. See, e.g., *SEC v. Great Am. Indus., Inc.*, 407 F.2d 453, 463-64 (2d Cir. 1968) (Hays, J., concurring).

59. *Speed v. Transamerica Corp.*, 99 F. Supp. 808, 829 (D. Del. 1951).

60. 40 S.E.C. at 911. This is the second aspect of the Commissioner's test, "the inherent unfairness involved." *Id.* at 912.

61. 445 U.S. at 251 (Blackmun, J., dissenting).

62. *Id.* at 248 (Blackmun, J., dissenting) (quoting H.R. REP. NO. 229, 94th Cong., 1st Sess. 91, reprinted in 1975 U.S. CODE CONG. & AD. NEWS, 321).

Justice Blackmun's dissent and the Second Circuit opinion supporting application of the parity rule pointed to *Affiliated Ute* as authority for the proposition that strategic position in the market place gives rise to an affirmative duty to disclose.<sup>63</sup> Indeed, the Supreme Court in *Affiliated Ute* noted that "by repeated use of the word, 'any,' [the statute and rule] are obviously meant to be inclusive."<sup>64</sup>

The majority, however, refused to give such a broad interpretation to either the statute or to *Affiliated Ute*. The Court stated that "[f]ormulation of such a broad duty, which departs radically from the established doctrine that duty arises from a specific relationship between two parties . . . should not be undertaken absent some explicit evidence of congressional intent . . . . [N]either the Congress nor the Commission ever has adopted a parity-of-information rule."<sup>65</sup>

The Supreme Court's reversal on this ground is not a surprising result. The Second Circuit's test of "regular access to market information" was an incomplete one. The Second Circuit conceded that would-be tender offerors may purchase up to five percent of the target's stock without making any disclosure.<sup>66</sup> If equalization of access to information were the underlying theory of rule 10b-5, then certainly, tender offerors would come within the ambit of the rule. Furthermore, adoption of such a theory would mean that mere possession of inside information would be sufficient to trigger liability, yet the courts have adhered to the *Cady, Roberts* analysis which requires some *relationship* before liability will be imposed.<sup>67</sup> Parity of access to information would represent a significant departure from established 10b-5 doctrine.<sup>68</sup>

### C. The Common Law Approach

While rejecting the Second Circuit's parity of access to informa-

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63. 445 U.S. at 251 (Blackmun, J., dissenting). Justice Blackmun, who wrote the majority opinion in *Affiliated Ute*, noted with displeasure the narrow interpretation that the majority seemed to be giving the case. "As I now read my opinion there for the Court, it lends strong support to the principle that a structural disparity in access to material information is a critical factor under Rule 10b-5 in establishing a duty either to disclose the information or to abstain from trading." *Id.*

64. 406 U.S. at 151.

65. 445 U.S. at 233.

66. 588 F.2d at 1366. This is permitted by § 13(d)(1) of the Act, 15 U.S.C. § 78m(d)(1) (1976). See *supra* note 45. Additionally, the Second Circuit did not overrule its decision in *General Time Corp. v. Talley Indus.*, 403 F.2d 159 (2d Cir. 1968), *cert. denied*, 393 U.S. 1026 (1969).

67. See *supra* note 39 and accompanying text.

68. Fleischer, *supra* note 34, at 816.

tion theory, the Court discussed under what circumstances liability would attach under section 10(b) and rule 10b-5. The Court discussed the development of nondisclosure cases and focused its attention on the underlying common law nature of the relationships involved in earlier cases. It explained that the relationships in *Cady, Roberts* and in common law cases imposing liability on corporate insiders vis-a-vis their shareholders were premised on the use of confidential information obtained "by reason of their position with that corporation."<sup>69</sup> The Court cited *Texas Gulf Sulphur* for the proposition that corporate insiders may not trade on the basis of undisclosed information<sup>70</sup> but did not address the Second Circuit's broad language in that opinion. The Court also explained that its approach in *Affiliated Ute* was not as broad as it may have appeared. Rather, the *Chiarella* Court noted that the *Affiliated Ute* case was consistent with common law theories of duty, pointing to dictum in *Affiliated Ute* that if the "bank had functioned merely as a transfer agent, there would have been no duty of disclosure."<sup>71</sup>

Many previous cases had stated that section 10(b) was designed to begin where common law concepts of fraud ended<sup>72</sup> and had gradually expanded the reach of the statute. However, the Court in *Chiarella* suggested that it would curtail such expansion in nondisclosure cases and would reestablish ties with the common law notions of relationship. It warned that section 10(b) is "aptly described as a catchall provision, but what it catches must be fraud."<sup>73</sup> Consistent with its concern for the common law, the Court formulated a rather stringent test for outsider liability in nondisclosure cases. Mere silence in connection with the purchase or sale of securities is insufficient to establish liability absent the existence of some independent, affirmative duty to disclose.<sup>74</sup> The Court concluded that such a duty arises where there is a relationship of "trust and confidence *between [the] parties to [the] transaction*."<sup>75</sup>

In applying this test to the facts of the case, the Court noted that no duty to disclose could have arisen from *Chiarella's* relationship with

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69. 445 U.S. at 228.

70. *Id.* at 229 (citing *Texas Gulf Sulphur*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969)).

71. 406 U.S. at 152.

72. *Id.* at 151; *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12 (1971); *A.T. Brod & Co. v. Perlow*, 375 F.2d 393, 397 (2d Cir. 1967).

73. 445 U.S. at 234-35.

74. *Id.*

75. *Id.* at 230 (emphasis added).

the sellers of target stock. He had had no prior dealings with them and was a complete stranger who dealt with the sellers only through impersonal transactions. The Court found it important that "he was not a person in whom the sellers had placed their trust and confidence."<sup>76</sup> Thus, the Court distinguished Chiarella from a corporate insider who has a duty to disclose. The Court also recognized that "tippees" have been held liable under section 10(b) "because they have a duty not to profit from the use of inside information that they know is confidential and know or should know came from a corporate insider."<sup>77</sup> Under this rationale, the tippee is liable as a participant after the fact in the insider's breach of his fiduciary duty. Chiarella was not a tippee, however, because he had received no confidential information from the target companies whose stock he traded. If he had, presumably, his conviction would have been affirmed.

Under a strict reading of the majority opinion, therefore, in non-disclosure cases, noninsiders would not be held liable under section 10(b) or rule 10b-5 unless the noninsider undertook to act on behalf of the shareholders.<sup>78</sup> The problem, however, is that the majority opinion was premised on a theory of a breach of a duty by Chiarella to target shareholders. Under this theory, and absent the Court's adoption of a parity of access to information theory,<sup>79</sup> no liability could have arisen from Chiarella's activities. There existed no relationship between Chiarella and target shareholders. The Court, however, has left it unclear as to just how strictly the opinion is to be read. The Court posed one theory on which liability may be based, but in side-stepping an alternative theory—that of misappropriation<sup>80</sup>—the Court left open the possibility of the statute's application under another theory in future cases with a *Chiarella*-type fact pattern.

#### D. Misappropriation

The majority opinion referred to, but did not decide, the possibility of the application of a new theory of liability under rule 10b-5 based

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76. *Id.* at 232. This is premised on the fact that Chiarella gleaned his information from documents he received from the acquiring companies and the stock he purchased was from the target corporations. *Id.* at 231.

77. *Id.* It is interesting to note that the Court simply noted the fact that tippees have been held liable, but voiced no opinion as to whether the Court approved or disapproved of tippee liability.

78. If the defendant had undertaken to act on behalf of the shareholders, presumably, the Court's present reading of the *Affiliated Ute* test would be met.

79. See *supra* notes 54-68 and accompanying text.

80. See *infra* notes 81-88 and accompanying text.

on misappropriation. The theory argued by the Government and advocated by Chief Justice Burger in his dissent<sup>81</sup> was that Chiarella breached a duty to the acquiring corporation when he acted on confidential information he obtained by virtue of his position with the financial printer. The breach of this duty of confidentiality, according to the theory presented, supported a conviction under section 10(b) for fraud perpetrated upon both the acquiring companies and the sellers of target stock.<sup>82</sup> The Chief Justice would have read the antifraud provisions to "encompass and build on this principle: to mean that a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading."<sup>83</sup> Justice Brennan, in a concurring opinion,<sup>84</sup> also supported such a position, stating that "a person violates § 10(b) whenever he improperly obtains or converts to his own benefit nonpublic information which he then uses in connection with the purchase or sale of securities."<sup>85</sup> The majority, however, refused to decide the issue of misappropriation. It simply noted that the jury instructions did not present the issue to the jury and that therefore a decision on the theory would be inappropriate.<sup>86</sup>

The theory of misappropriation is narrower than the parity of access to information theory. The misappropriation theory begins with the general rule that neither party to an arm's length transaction has an obligation to disclose information to the other unless the parties stand in some confidential or fiduciary relation. Thus, a businessman may capitalize on his experience and skill in evaluating relevant information. The rule does not preclude any individual with material nonpublic information from trading so long as the information was obtained legally and not unlawfully converted for his or her own use. For instance, tender offerors would not come within the ambit of the theory since that information would be legally obtained and used for a legitimate corporate purpose.

The rule comes into play, according to the Chief Justice's dissent, "when an informational advantage is obtained not by superior experi-

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81. 445 U.S. at 239 (Burger, C.J., dissenting).

82. *Id.* at 235.

83. *Id.* at 240 (Burger, C.J., dissenting).

84. *Id.* at 238 (Brennan, J., concurring).

85. *Id.* at 239 (Brennan, J., concurring).

86. "[W]e do not believe that a 'misappropriation' theory was included in the jury instructions." *Id.* at 237 n.21. "Because we cannot affirm a criminal conviction on the basis of a theory not presented to the jury . . . we will not speculate upon whether such a duty exists, whether it has been breached, or whether such a breach constitutes a violation of § 10(b)." *Id.* at 236-37 (citations omitted).

ence, foresight, or industry, but by some unlawful means.”<sup>87</sup> Under these circumstances, the person who has misappropriated information has an affirmative duty of disclosure before trading in the securities. According to this theory, because he “stole” valuable corporate information given to him in confidence and then used that information for his own personal advantage, Chiarella violated section 10(b) and rule 10b-5.

Whether misappropriation encompasses the type of activity that the statute was intended to reach is uncertain both from the language of the statute and from the Court’s opinion in *Chiarella*. The position taken by the majority does not foreclose the possibility that, given appropriate jury instructions, the Court would uphold a conviction or find civil liability based on that theory. The majority opinion was not inconsistent with the misappropriation theory.<sup>88</sup> If it were inconsistent, the Court certainly would have rejected the theory.

There are, however, some unanswered questions posed by the misappropriation theory, particularly on the issue of damages. If the underlying duty to disclose is premised upon a confidential relationship to the acquiring companies and the breach of a duty of confidentiality operates as a fraud upon those companies, then, arguably, those companies who are neither purchasers nor sellers of the stock would have no damages. Hence, there would be no actionable violation.<sup>89</sup> If this were the case and the Court were to adopt the misappropriation theory, a situation could arise wherein a person could be subject to criminal prosecution under rule 10b-5 and yet not be liable for damages in a civil action. If, on the other hand, the Court were to find that an action for damages would lie, it is uncertain what the measure of those damages would be.

Regardless of the difficulties posed by the adoption of the misappropriation theory, the theory does seem to be consistent with the principle that “the broad language of the antifraud provisions” should not be “circumscribed by fine distinctions and rigid classifications” such as those that prevailed at common law.<sup>90</sup> The use of rule 10b-5 in these

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87. *Id.* at 240 (Burger, C.J., dissenting).

88. The Chief Justice stated his “understanding that the Court has not rejected the view . . . that an absolute duty to disclose or refrain arises from the very act of misappropriating nonpublic information.” *Id.* at 243 n.4 (Burger, C.J., dissenting).

89. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

90. *Cady, Roberts & Co.*, 40 S.E.C. at 912. This position was also endorsed by Commissioner Smith in his concurring opinion in *In re Investors Management Co.*, [1970-1971 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78,163 (July 29, 1971). The Commissioner stated: “A duty not to steal or knowingly receive stolen goods or exercise dominion over



-situations would be as a disciplinary device rather than a compensatory one.<sup>91</sup>

#### IV. CONCLUSION

The *Chiarella* Court has left open the future of rule 10b-5. It is certain from the opinion that parity of information is not the proper basis for imposition of liability under the antifraud provisions of the Act. What is not clear is how strict the Court will be in future cases as to the requirement of a relationship between the parties to the stock transaction. The Court has carefully formulated a test for liability based on common law notions of relationships, but has reserved opinion as to misappropriation as a triggering device.

To adopt the trust and confidence doctrine as the sole basis for liability under the antifraud provisions would unduly restrict those provisions, and create an unnecessary distinction between inside information and market information.<sup>92</sup> Such an approach would minimize "the importance of . . . access to confidential information that the honest investor, no matter how diligently he tried, could not legally obtain."<sup>93</sup>

Adoption of the misappropriation theory as an additional theory for 10b-5 liability, however, would be consistent with the underlying purposes of section 10(b)<sup>94</sup> and would retain some of the elasticity with

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goods known to be owned by others exists toward the corporation even without the presence of a special relationship." *Id.* at 80,524 n.2.

91. See Painter, *Inside Information: Growing Pains for the Development of Federal Corporation Law Under Rule 10b-5*, 65 COLUM. L. REV. 1361, 1393 (1965).

92. "Market information refers to information about events or circumstances which affect the market for a company's securities but which do not affect the company's assets or earning power." Fleischer, *supra* note 34, at 799. Market information is frequently outside information generated by sources outside the company whose shares are affected. *Id.* at 807.

93. 445 U.S. at 247 (Blackmun, J., dissenting) (emphasis in original).

94. "As Congress itself has recognized, it is integral to this purpose 'to assure that dealing in securities is fair and without undue preferences or advantages among investors.'" *Id.* at 248 (Blackmun, J., dissenting) (quoting H.R. CONF. REP. NO. 94-229, at 91 (1975)). Recently, the SEC enacted rule 14e-3, 45 Fed. Reg. 60,410, 60,418 (1980) (to be codified in 17 C.F.R. § 240.14e-3), an antifraud provision establishing a "disclose or abstain rule" for any person who is in possession of material information he or she knows or has reason to know is nonpublic and was acquired, directly or indirectly, from that person or the issuer of the securities subject to tender offer. The rule also establishes an anti-tipping rule with respect to nonpublic information relating to a tender offer, which proscribes conduct such as *Chiarella's*. However, the new rule is not applicable to merger situations so that another *Chiarella*-type situation could arise under 10b-5.

The Commission has stated its belief, however, that misappropriation comes within the ambit of section 10(b). "The Commission continues to believe that [misappropriation] undermines the integrity of, and investor confidence in, the securities market, and that persons

which the broad statute was drafted. The theory also falls within the *Cady, Roberts* analysis. It would require a relationship giving access to nonpublic information and would only be triggered when the information so obtained was not used for a legitimate corporate purpose. Thus, the adoption of the misappropriation theory would allow corporations to make required disclosures under the Act without fear that that information would be exploited before it was made public.

*Kerry Cunningham Feffer*

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who unlawfully obtain or misappropriate material, nonpublic information violate rule 10b-5 when they trade on such information." *Id.* at 60,412.

